

David J Hatton
Director — Federal Regulatory Accounting

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Federal Communications Commission
Office of Secretary

October 10, 1996

EX PARTE

William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: CC Docket No. 96-150, Accounting Safeguards - Section 272 of the
Communications Act

Today, I met with members of the Common Carrier Bureau's Accounting and Audits Division, Kenneth Ackerman - Chief of Accounting Systems Branch, Jose-Luis Rodriguez - Chief of Audits Branch, Robert Hood - Deputy Chief of Audits Branch and attorneys for the Division, Robert Ehrlich, John Giusti and John Hays to discuss the information shown in the attached. Please associate this material with the above-referenced docket.

Two copies of this notice are submitted in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the copy to confirm your receipt. Please call me if you have any questions.

Sincerely,


Attachment

CC: Kenneth P. Moran
Clifford M. Rand
Kenneth M. Ackerman
Jose-Luis Rodriguez
Robert E. Hood
Mark Ehrlich
John Giusti
John Hays

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SECTION 272 BIENNIAL AUDITS:

- **Audit Scope:**

Section 272(d)(1) Biennial Audit - General Requirement sets forth the audit scope and should be adopted in the Order. The scope is limited to determining whether the subject company has complied with Section 272 of the Act and the regulations promulgated under this section with particular emphasis on separate accounting requirements in subsection (b) Structural and Transactional Requirements.

- **Audit Process:**

1. Commission should conclude that the biennial audit should be conducted promptly following the first full calendar year of operations as a Section 272 affiliate.
2. Since the audit process is unique for each subject LEC, the Commission should not adopt language in its Order that attempts to formalize the audit process.
3. FCC should not conclude that a specific audit process be adopted in this proceeding since there is no assurance that federal and state resources will be available to participate in all audits.
4. The individual LEC biennial audits need an agreed to process to ensure that all participants in the audit understand the scope and timing of the biennial audit.
5. The audit process agreed to for the first biennial audit may differ substantially in subsequent biennial audits.

6. Interested parties in the audit process are the subject LEC, audit firm, federal and state commissions since the ACT specifically refers to the audit as a joint federal/state audit.
7. NARUC has proposed an audit guideline that contains presumptions that have not been agreed to previously by the LECs nor the independent audit firm who will conduct the audit.
8. While some of the specific recommendations in NARUC's audit guideline are appropriate, the expectations regarding the audit process should be separately addressed outside of the audit scope.
9. NYNEX proposes that the federal and state commissions who want to participate in the NYNEX Section 272 biennial audit process meet with the company and audit firm with a view towards agreeing to a specific process prior to the start of the audit. It will be more effective to participate at both the front end of the audit planning period and at the end of the audit following the issuance of the audit report.
10. While the audit is an absolute requirement, there is no requirement that federal and state commissions participate in the actual undertaking of the audit.
11. There should be no requirement for an RFP as proposed by NARUC since this is simply an available option.
12. Companies may choose to use the existing auditors of the cost allocation manual since the annual audit of affiliate transactions is conducted as a component of the presents fairly audit. It is completely consistent to engage the same audit firm to conduct the separate agreed to procedures audit of Section 272 affiliates encompassing all of the specific requirements in Section 272. **A separate audit report on the agreed to procedures audit can be obtained in an independent manner with minimum duplication of the cost allocation manual audit.**

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FAIR MARKET VALUE:

1. Under rate base rate of return regulation, absent existing rules, assets transferred from regulation to affiliates at FMV less than net book cost will result in losses charged to ratepayers. Assets transferred at FMV more than net book cost will result in gains benefiting the ratepayers. The existing asset transfer rules protect and benefit the telephone ratepayer, e.g., the ratepayer is protected against the possibility of losses from transfer of assets to affiliates.
2. The maximum protection for ratepayers regarding services provided to an affiliate is to restrict services to cost, absent a tariff or prevailing market price. Services, unlike assets, should not yield gains in a transfer, again absent a tariff or prevailing market price, nor is there any economic argument to impose a standard to guarantee gains in transactions for services. The proposal to impute a FMV for services is an attempt to create a gain for services on the regulated books of account. Since this is completely void of any economic reality, there is no justification for this option. The costs recorded by the Section 272 affiliate are not real unless the transaction is economically sound and consistent with the internal corporate costs.
3. Forcing telephone companies to record derived (fictitious) valuations for services will not produce any incremental safeguards for Section 272 affiliates or regulated telephone companies. Barring a tariff rate or prevailing market price in an open competitive market place for services, the internal costs of the transactions are the only real economic events. The fact that a telephone company is forced to record a different value will not change the affiliate's ability to compete in a free market place.
4. Allowing inter affiliate services to be recorded at prevailing market prices assumes that the service is available in an open market place. To the extent that there is a real economic option for the service, an affiliate has choices and will exercise those choices for the source of the service.
5. The cost of services provided by affiliates is the sum of internal and external current costs. The external costs are for components of services procured from the nonaffiliates and utilized within the enterprise. The internal costs include the current wages and benefits of employees. Both of these costs are in fact current and market

based costs. The requirement for evaluating services at a FMV serves no purpose when the service is provided at a cost made up of current costs obtained in a free and competitive market place.

6. Assets, on the other hand, are based on original costs that were incurred in a prior period. To the extent that such assets are transferred to an affiliate, the rule to evaluate the asset in the current market place is not inconsistent.
7. Services provided by affiliates within the consolidated group that are not also provided by the affiliate in a competitive market place are generally not likely to exist in the market place as readily available. Such services are:
 - Technically more appropriate to provide internally.
 - Are provided with both internal and external resource to the appropriate extent necessary.
 - Are sensitive to confidentiality and proprietary concerns and cannot be outsourced.
 - Are of a corporate governance nature that precludes outsourcing and thus, prevents any possibility for evaluation at FMV.
8. Imposing the recording of affiliate service transactions at FMV when the only basis for the transaction was original cost is inconsistent with generally acceptable accounting principles as embodied within Part 32, USOA.
9. Imposing the recording of affiliate service transactions at FMV will result in a finding that there is no audit trail for the transaction that can be legitimately traced back to the origin of the service.
10. Questions of prudence of management decisions to provide services to affiliates is outside the scope of this proceeding. Specifically, concerns with the prudence of costs incurred in providing internal affiliate services should not be the subject of this proceeding on accounting safeguards.
11. The Commission's existing affiliate transaction rules have the appropriate order of evaluating affiliate transactions for services; tariff rates, prevailing market price or fully distributed costs. This order of compliance requirement is consistent with economic reality, is auditable and is a reasonable accounting safeguard for preventing perceived abuses.
12. Imputing FMV as proposed in this proceeding that has not been tested nor researched nor verified as a reliable basis for cost should be set aside. Support of this proposal in this proceeding has not provided any specific documentation proving that such a theory works in practice.

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SECTION 272 AFFILIATE BOOKS OF ACCOUNT:

ACT: Section 272 affiliate must maintain books, records and accounts in the manner prescribed by the Commission.

FCC has asked, in this proceeding, whether they should mandate that the affiliate maintain their books, records, and accounts in accordance with GAAP.

FCC has not proposed any other alternatives, although it seeks comments on whether any additional requirements should be imposed for the affiliates.

Commentors have proposed that the Commission require that Section 272 affiliates use Part 32, USOA.

1. Commission should mandate that the affiliate maintain its books, records, and accounts in accordance with GAAP. This adoption in the final Order would clearly establish the requirements and recognize the significance of GAAP.
2. The Part 32 USOA Rules are not necessary for Section 272 affiliates to comply with the accounting safeguards requirements.
3. The FCC and state auditors have historically demonstrated that GAAP books are acceptable. The FCC and state auditors are professionally qualified to work with various systems of account that rely on GAAP. NYNEX corporate and its affiliates have been audited by the FCC and state auditors since 1984. No audit reports have ever noted that the GAAP books restricted the ability to perform the audits.
4. GAAP books for Section 272 affiliates can be in place with minimal incremental accounting modifications since all nonregulated affiliates of NYNEX use the same basic system of accounts.
5. Conversion to Part 32 USOA is costly in terms of both human resources and accounting software modifications and provides no useful information that is not already available on GAAP books.
6. The real substance of the financial information in accounts is the result of accounting policies. Subsidiary accounting records and reports provide the details that allow for efficient audits and reviews.
7. There is nothing so extraordinary about Section 272 affiliates that would warrant adoption of additional accounting requirements.

8. Requiring Section 272 affiliates to follow Part 32 USOA would impose a regulatory burden and competitive disadvantage, since competitors would not be subject to these requirements.